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Report Highlights:

With the UK holding large stocks of cigarettes and sterling strong on international markets, UK production of cigarettes fell sharply in CY2003 to just 108 billion pieces, down 25 billion pieces on CY2002. This led to a parallel decline in imports of unmanufactured tobacco. With market conditions forecast to be little changed in CY2004, cigarette production is forecast at just 105 billion pieces this year and imports of unmanufactured tobacco are forecast to remain under pressure. As is traditional, over half of the cigarettes produced will be exported. Consumption of duty-paid cigarettes continues to decline in the UK but is being replaced by consumption of personal or black market non-duty paid imports or of alternative tobacco products. Indeed, consumers are increasingly switching to hand rolled tobacco (RYO), a sector of the market associated with older clientele but now gaining a following among young smokers.

Includes PSD Changes: Yes
Includes Trade Matrix: Yes
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Explanatory Notes

Stocks

The format of the production, supply and demand (PSD) table for cigarettes featured in this report makes no allowances for stocks. The trade information is, therefore, distorted when it is reported in the PSD and in turn affects the supply and distribution totals. To remedy this problem the actual market conditions are described in separate tables within the body of the text. References to market data therefore relate to these tables and not the traditional PSD table which can be found in the statistical appendix.

Exchange Rates

This report refers to sterling's competitiveness against other currencies. The following table provides yearly average exchange rates for sterling against the U.S. dollar and the Euro. The latter currency replaced the European Currency Unit (ECU) on 1 January, 1999 and entered full circulation in the participating European countries on 1 January, 2002.

Following three years of steady decline in sterling's value against the dollar, 2002 saw the trend reverse. Indeed, sterling continued to show gains against the dollar right through until mid February 2004 when it hit an 11 year high before weakening slightly in recent weeks. On the EU market, sterling's value against the Euro has been less volatile since the sharp increase in sterling's value relative to the Euro in 2003.

Year	Euro per BPS	USD per BPS
1995	1.207	1.579
1996	1.229	1.561
1997	1.443	1.639
1998	1.479	1.657
1999	1.5192 (1)	1.618
2000	1.642	1.516
2001	1.608	1.441
2002	1.587	1.499
2003	1.445	1.634
2004 (2)	1.476	1.828
29-Apr-04	1.489	1.773

(1) Euro superceded ECU from January 1, 1999

(2) January – April 2004 average

Source: Bank of England

Throughout the report the rate of exchange used is BPS 1 = USD 1.75

Executive Summary

The UK tobacco industry is dominated by three national companies – Gallaher Ltd, Imperial Tobacco Ltd and British American Tobacco (BAT), the latter operating as Rothmans (UK) Ltd. BAT is the only one of the three to be based in the UK and, since its merger with Rothmans, is the world's second largest tobacco company with a global market share of 16 percent, just behind the U.S. company Philip Morris which has 17 percent of the world market. In the UK, all three companies predominantly produce cigarettes but also manufacture hand rolling tobacco (RYO), pipe tobaccos and cigars for the UK and export market.

This report focuses on unmanufactured tobacco and cigarettes, the two most important elements in the UK tobacco market. Although the UK imports all of its tobacco leaf, it is a substantial exporter of finished tobacco products, mainly cigarettes, to the Far and Middle East and Eastern Europe. In CY2003, the UK tobacco export market was worth around BPS927 million (USD1.6 billion). Although little changed on CY2001, this is BPS57 (USD100) million less than CY2002 and significantly lower than in the 1990s, a reminder that the UK is still struggling to recoup export volumes lost following the economic downturn in the Far East in the late 1990s. Domestic consumption of duty-paid cigarettes remains in long-term decline and, combined with year on year falls in export volumes, UK cigarette producers are finding themselves under considerable pressure. As such, production is forecast to fall to just 100 billion pieces in CY2004.

There are currently some 12 million adult cigarette smokers in the UK, 28 percent of adult men and 26 percent of adult women. Thirty years ago, 51 percent of adult men and 41 percent of adult women smoked cigarettes, nearly half of the adult population compared with a quarter today. The decline has largely been in the older population; almost as many young people are taking up smoking cigarettes but more established smokers are quitting. In addition, an increasing number of smokers are turning to alternate tobacco products.

Total duty-paid consumer expenditure on all tobacco products was more than BPS12.5 (USD22) billion in CY2002, the latest year for which data is available. This was spent on 56 billion cigarettes, 872 million cigars, 2,805 tons of hand rolling tobacco and 535 tons of pipe tobacco. However, it is widely accepted that these figures mask the true total UK expenditure on, and consumption of, tobacco products as many consumers turn to personal or black market non-duty paid imports. For example, in the ten years to 2002 after the European Single Market was formed in 1993, and cross-channel trade began in earnest, officially reported UK cigarette sales to the trade declined 39 percent. That said, over the same ten years, cigarette consumption declined just 15 percent to around 76 billion pieces in CY2002, the non-duty paid consumption of cigarettes having increased from just 3.5 billion pieces in CY1993 to an estimated 20 billion pieces in CY2002. Further, once RYO is included, cigarette consumption is virtually unchanged.

UK taxes on tobacco products generated almost BPS10 (USD17.5) billion in CY2002, equivalent to around 4 cents in the dollar on the basic national rate of income tax. With the highest incidence of tobacco tax in the EU, the tax (excise duty plus value added tax) currently accounts for just under 79 percent of the price of the leading brand of cigarettes in the UK. Consequently, UK tobacco prices are among the highest in the world. Although the average pack of 20 cigarettes in the UK can cost over three times as much in other EU countries such as Spain and Portugal, it is the difference on hand-rolled (RYO) tobacco that is most marked, with popular brands costing between four and five times more in the UK than they do in Belgium. As such, it is unsurprising that UK Customs estimate that 21 percent of the cigarettes smoked in the UK in CY2002 were bootlegged or smuggled while a further 7 percent were legally purchased overseas. It is also unsurprising that the RYO market has more than doubled in the past ten years and continues to show strong growth, particularly

when the UK's Tobacco Manufacturers Association estimates that 70 percent of that market is non-duty paid.

While government initiatives to stop smuggling may curb the illegal imports somewhat, legitimate trade in non-duty paid tobacco will continue, if not increase, as long as the tobacco price differentials between the UK and other EU countries remain. Government anti-smoking initiatives may eventually reduce domestic consumption but these figures are not expected to decline by much in the near future.

Unmanufactured Tobacco

PSD Table

United Kingdom Tobacco, Unmanufactured, Total							
	2002	Revised	2003	Estimate	2004	Forecast	UOM
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	
Market Year Begin		01/2002		01/2003		01/2004	MM/YYYY
Area Planted	0	0	0	0	0	0	(HA)
Beginning Stocks	20577	20577	16928	16928	20678	11031	(MT)
Farm Sales Weight Prod	0	0	0	0	0	0	(MT)
Dry Weight Production	0	0	0	0	0	0	(MT)
U.S. Leaf Imports	4265	4265	4000	2962	0	4000	(MT)
Other Foreign Imports	100376	100376	105000	84951	0	96000	(MT)
TOTAL Imports	104641	104641	109000	87913	0	100000	(MT)
TOTAL SUPPLY	125218	125218	125928	104841	20678	111031	(MT)
Exports	13090	13090	11000	13810	0	15000	(MT)
Dom. Leaf Consumption	0	0	0	0	0	0	(MT)
U.S. Leaf Dom. Consum.	4000	4000	3750	2750	0	3750	(MT)
Other Foreign Consump.	91200	91200	90500	77250	0	74250	(MT)
TOTAL Dom. Consumption	95200	95200	94250	80000	0	78000	(MT)
TOTAL Disappearance	108290	108290	105250	93810	0	93000	(MT)
Ending Stocks	16928	16928	20678	11031	0	18031	(MT)
TOTAL DISTRIBUTION	125218	125218	125928	104841	0	111031	(MT)

Contrary to previous expectations, UK imports of unmanufactured tobacco fell sharply in CY2003. Brazil and Zimbabwe remained the two key suppliers to the UK although both saw large reductions in the volume traded. Imports from China, which showed a considerable rise in CY2002, were again strong in CY2003. India and Italy (most of the latter's leaf being transshipped product from Sri Lanka and India) completed the top five who together accounted for almost two thirds of the total volume last year. Imports from the U.S., which have traditionally been around 4,000 MT faltered in CY2003 as they did in CY2001. Available data continues to indicate that stocks are becoming increasingly depleted suggesting that some increase in import volume should be expected in CY2004.

At less than 15,000 MT, UK exports of unmanufactured tobacco are small. Traditionally, the key markets have been France and Ireland who in the past have together accounted for over 50 percent of the total export market. However, CY2003 saw over 3,000 MT of unmanufactured tobacco exported to Germany, a market previously untapped by the UK. The total export volume is forecast to remain small in CY2004.

UK consumption of tobacco leaf fell to just 80,000 tons in CY2003, reflecting a sharp decline in cigarette production in the UK. With cigarette production forecast little changed in CY2004 and imports currently forecast to rise, some build up in stocks from their current very low level is foreseen.

Trade Matrices

Import Trade Matrix United Kingdom Tobacco, Unmanufactured, Total			
Time Period:	Jan-Dec	Units:	MT
Imports for:	2002		2003
U.S.	4265	U.S.	2962
Others		Others	
Brazil	33347	Brazil	24211
Zimbabwe	19501	Zimbabwe	13831
China	8922	China	6410
India	6164	India	5049
Italy	4234	Italy	5030
Belgium Lux	3123	Argentina	4135
Uganda	2937	Spain	4067
Spain	2743	Uganda	2733
Canada	2661	Kenya	2719
Argentina	2581	Netherlands	2462
Total for Others	86213		70647
Others not Listed	14163		14304
Grand Total	104641		87913

Export Trade Matrix United Kingdom Tobacco, Unmanufactured, Total			
Time Period:	Jan-Dec	Units:	MT
Exports for:	2002		2003
U.S.	1	U.S.	43
Others		Others	
France	3865	Germany	3374
Ireland	3390	France	3091
Singapore	1217	Ireland	2604
Bangladesh	1155	Singapore	1696
Kazakhstan	941	Russia	783
Austria	426	Spain	591
Spain	340	Kazakhstan	447
Ukraine	304	South Africa	205
Germany	193	Kenya	154
Latvia	182	Netherlands	132
Total for Others	12013		13077
Others not Listed	1076		690
Grand Total	13090		13810

Cigarettes

	2002	2003	2004
Opening stocks	532192	547331	540173
Production	133014	107922	105000
Imports	10494	6493	5000
Exports	72369	68073	598673 (1)
Duty-paid consumption	56000	53500	51500
Private/Illegal Imports	20000	20500	20500
Total consumption	76000	74000	72000
Closing stocks	547331	540173	0

(1) Total available to export/re-export during 2004

UK cigarette production is estimated to have fallen 19 percent to just 108 billion pieces in CY2003. Following a large spike in imports in CY2001, the UK is thought to be carrying large stocks of cigarettes and trade sources cite increased clearances (cigarettes cleared for home consumption and therefore liable for excise duties) as the major factor at play. A similar outlook is currently forecast for CY2004.

The UK cigarette market continues to be characterized by down trading of one form or another. As the price of duty-paid cigarettes has risen, such that a packet of twenty premium brand cigarettes now costs around BPS4.65 (USD8.1), cigarette smokers have unsurprisingly looked for alternatives. As highlighted in previous reports, some have turned to purchasing smaller packets, an area of the market which continues to show good growth, but others are taking more drastic measures such as seeking out alternatives to their usual brands or switching away from filter cigarettes altogether. While for many this has meant down trading from premium to middle-priced brands before the almost inevitable move to an economy or ultra-low price brand, for others a switch to RYO has been the answer. As such, while cigarette consumption appears to be in downward decline, falling from 76 billion pieces in CY2002 to an estimated 74 billion pieces in CY2003 and forecast to fall to 72 billion pieces in CY2004, consumption of RYO (be it consumers switching totally or becoming cigarette/RYO dualists) has risen such that 'true' cigarette consumption appears to be much more stable, albeit in slight decline.

In a cigarette market that is worth almost BPS11 (USD19.25) billion, the major companies have reacted to consumer demand for cheaper cigarettes by launching their own economy brands which have subsequently proved very successful. The top selling economy brand is Lambert & Butler King Size. It grew its share of sales by 1.6 percent to BPS1.3 (USD2.3) billion in CY2003 while premium Benson & Hedges Gold King Size retained its second place in the market but dropped its share from 9 percent to 8.4 percent with sales of BPS1 (USD1.75) billion. Indeed, the only premium brand in the UK top 15 to gain share was Marlboro Gold (Lights) King Size, a result of its lifestyle branding according to market sources. Overall, consumers are seeking economy and, as a consequence, Gallaher's "value-

for-money" Mayfair brand continues to show great success while Imperial's Richmond brand continues to go from strength to strength.

For the many consumers who trade down even further to non-duty paid cigarettes, these can be either legally imported or, more likely, otherwise. On the black market, premium brands cost little more than half the price of the legal equivalent and around BPS1 (USD1.75) lower than the cost of the lowest ultra-low price brand. In CY2003, it is estimated that of the total 74 billion cigarettes smoked in the UK, 20.5 billion were non-duty paid of which three quarters were illegally smuggled into the UK with the remainder being legitimate cross border, duty-free purchases.

As noted previously, but worth noting again, those who trade down to hand rolled tobacco will likely be smoking smuggled goods - around 70 percent of the RYO market is allegedly accounted for by illegal imports

Most UK duty-paid consumer demand is met by domestic production and stocks. Indeed, the UK maintains a positive trade balance in the cigarette market, exporting over a half of all production. It is also currently holding substantial stocks. The most important export markets for the UK in value terms are Germany (increasingly via Belgium), the Netherlands and Spain in the EU, Hong Kong in the Far East, Saudi Arabia in the Middle East and Nigeria in Africa. While CY2003 saw a further decline in exports, most traders remain positive regarding CY2004 trade.

Nearly all of the UK's recorded cigarette imports come from other EU countries with Germany accounting for over 60 percent of the CY2003 total of just 6.5 billion pieces. In addition to the legal imports, and as highlighted previously, it is estimated that a further 20.5 billion cigarettes entered the country as personal or illegal imports in CY2003. CY2004 is expected to see a reduction in the smuggled and duty-paid imports while personal imports will remain steady, if not rise marginally.

Trade Matrices

Import Trade Matrix United Kingdom Tobacco, Manufacturing, Cigarettes			
Time Period:	Jan-Dec	Units:	MT
Imports for:	2002		2003
U.S.	1750	U.S.	5
Others		Others	
Germany	6056	Germany	3989
Portugal	801	Portugal	994
Netherlands	700	Netherlands	696
Belgium Lux	418	Denmark	514
Ireland	226	Ireland	147
Austria	194	Cyprus	72
Singapore	143	Switzerland	41
Denmark	78	Belgium	12
France	72	Austria	5
Switzerland	22	Dubai (UAE)	4
Total for Others	8710		6474
Others not Listed	34		14
Grand Total	10494		6493

Export Trade Matrix United Kingdom Tobacco, Manufacturing, Cigarettes			
Time Period:	Jan-Dec	Units:	MT
Exports for:	2002		2003
U.S.	953	U.S.	662
Others		Others	
South Korea	10916	Russia	8484
Nigeria	5011	Nigeria	5109
Hong Kong	4592	Spain	4612
Spain	4141	Saudi Arabia	3765
Singapore	3651	Hong Kong	3737
Saudi Arabia	3639	Armenia	3013
Netherlands	3140	Singapore	2517
Germany	3121	Greece	2241
Dubai (UAE)	2778	Taiwan	2241
Benin	2457	France	2091
Total for Others	43446		37810
Others not Listed	27970		29601
Grand Total	72369		68073

Policy Issues

Tax Policy

UK government policy towards tobacco taxes has remained largely unchanged since the Conservative government introduced the so-called escalator tax in the early 1990s, with the publicized aims of reducing consumption (particularly in children under the age of sixteen), thereby reducing the burden on the national health service of smoking-related diseases, and increasing revenue. The Labour administration, which took power in 1997 and was re-elected in 2001, has continued this policy with above inflation annual increases on tobacco taxes effectively becoming the norm. As such, the UK tobacco sector is one of the most heavily taxed in the world, and UK cigarette prices are the highest in the EU, with taxes accounting for around 80 percent of the retail cost of a typical packet of cigarettes. With prices approximately double those in nearby Belgium and the Netherlands, smuggling is a major problem.

	Retail Price	VAT	Ad Valorem	Specific	Total Tax	Tax Incidence
UK	465	67	99	188	365	78.6
Ireland	430	70	74	173	341	79.3
France	351	62	66	113	282	80.4
Finland	281	50	138	21	213	75.6
Sweden	298	46	149	10	208	69.6
Denmark	278	56	110	30	207	74.4
Belgium	250	32	56	85	186	74.4
Germany	237	39	104	26	177	74.7
Netherlands	214	35	87	30	156	73.0
Austria	211	32	41	74	155	73.7
Greece	190	28	99	6	138	72.5
Italy	176	29	94	6	131	74.7
Luxembourg	180	18	80	16	120	66.8
Portugal	148	23	33	56	115	77.7
Spain	137	19	73	5	98	71.8

Smuggling

The UK government estimates MY2002 revenue losses at BPS4.4 (USD7.7) billion split between BPS1.4 (USD2.45) billion in legitimate cross border purchases, up BPS200 (USD350) million on MY2001, and BPS3 (USD5.25) billion in smuggled tobacco products, down by a similar amount. These figures take into account the value of excise duty and Value Added Tax (VAT). Estimates suggest that over a quarter of all cigarettes sold in the UK in CY2002 were non-duty paid. Much has been made of the losses to the retail trade as a result of smuggling.

According to industry sources, without a change in UK tax policy, the non-duty paid sector will remain a significant one. The industry argues that as the price of cigarettes has risen, criminals, using distribution channels established for the illegal sale of RYO have increasingly

turned their attention to smuggling cigarettes. This has a much larger impact on excise revenues. The National Crime Intelligence Service has also suggested that the high profits and relatively low risks and penalties compared with other forms of serious and organized crime, such as drug trafficking, have exacerbated the problem. The trade also argues that illegal cigarettes and other tobacco products are so widely available that it is reducing the effectiveness of UK tax policy in curbing smoking and leading to higher and unregulated consumption than would otherwise be expected, sales to children being cited as a particularly emotive example.

Despite a Tackling Tobacco Smuggling Strategy, UK Customs expectations of curbing smuggling to any significant extent are low. Additionally, of course, any success in this area does nothing to stem the flow of legitimate cross border purchases which is, as noted above, is on the increase.

Anti Smoking Initiative

The UK government has made reducing the incidence of smoking a key health objective. Tobacco control in the UK consists of a mix of legal and voluntary measures.

The introduction of the EU tobacco directive has brought changes to all tobacco packaging manufactured for sale in the UK, and in some cases changed the product itself. All tobacco packaging must carry larger, clearer health warnings, which vary in size depending on the product. As an example, for cigarettes the front face of the packaging must incorporate a health warning covering no less than 30 percent of the surface area, while the rear of the pack must feature a health warning covering no less than 40 percent of the area, with both surrounded by a 3mm black border. Another part of the directive bans the use of terms such as Lights, Mild and Ultra and to accommodate this manufacturers are making changes to the names of some brands. Imperial Tobacco, for example, is utilizing colors to represent brand variants such as Lambert & Butler Gold (formerly Lights) and Embassy Blue (formerly Mild). From 1 January, 2004, tobacco products are now no longer allowed to exceed 10mg tar, 1mg nicotine and 10mg carbon dioxide and yield levels must be identified on the side of the packs, surrounded by a 3mm black border.

Also, in the UK specifically, after an initial failed attempt, the Government's Tobacco Advertising and Promotion Act became law in November 2002. Subsequently, press and poster advertising was banned from 14 February 2003, direct marketing and in pack promotion schemes from 14 May 2003, sponsorship of national events from July 2003 and of global events from 31 July 2005. Regulations on point of sale and brand sharing were notified to the EU Commission on 26 September 2003. The standstill period came to an end on 29 December 2003. No detailed opinions were forthcoming from Member States which means that the UK Government can publish the final regulations at any time. Retailers will then be given nine months to comply. Finally, in line with the changes to health warnings, the UK DUTY PAID mark carried on tobacco products has changed to black on white, again surrounded by a 3mm black border.

The UK also has a number of voluntary agreements on tobacco advertising and promotion but many of these will cease to apply as they become superseded by the legislation.

Trade sources suggest that the effective ban on advertising will make it almost impossible to launch new brands in the future with companies expected to focus their efforts on successful pre-existing brands.

Other Tobacco Products

RYO

The RYO market is the second most important tobacco market in the UK with around 5.5 million regular smokers and around 1 million dualists (those who smoke RYO and cigarettes). In recent years its popularity has grown as the cost of duty-paid cigarettes has continued to rise. Much of this consumption is of non-duty paid goods, unofficial estimates suggesting that of the total 10,000 tons consumed in CY2003, just 2,830 tons were duty-paid, the vast majority of the remainder having been illegally smuggled into the UK. Further, as an area that traditionally attracted an older clientele, it is interesting to note that it is becoming increasingly popular among young smokers. This becomes even more interesting given that market research indicates that once smokers have switched to RYO they are unlikely to switch back to cigarettes.

The major companies have reacted to the development of the RYO sector by introducing a number of innovative accessories from new style lighters to rolling machines to various color coordinated RYO products to thinner and lighter paper. The rolling paper sector alone is currently estimated to be worth BPS100 (USD175) million.

As long as UK cigarette taxes remain high, the RYO market and its accessory sector is expected to continue to show good growth.

Cigars

The UK cigar market is worth approximately BPS500 (USD875) million, with consumption in CY2003 totaling approximately 1 billion cigars. Overall cigar consumption has been in slow decline for a number of years in the UK. However, within the sector, small or miniature cigars continue to flourish at the expense of standard and large cigars to the extent that five of the top ten brands in the sector are now of this variety. Small cigars now account for around 50 percent of all cigar sales with increasing numbers of cigarette smokers partaking in the occasional small cigar. Indeed, such is the success of small cigars that the cigar sector overall continues to see growth in value terms despite the fall in volume purchases.

Pipe Tobacco

The pipe tobacco sector is in long term decline, falling around 10 percent each year. There are currently around 400,000 pipe smokers in the UK consuming around 600 MT of tobacco with the market estimated to be worth around BPS75 (USD131) million. As a niche market, characterized by older smokers, the market is expected to continue to shrink.

Appendix

PSD Table

United Kingdom Tobacco, Mfg., Cigarettes							
	2002	Revised	2003	Estimate	2004	Forecast	UOM
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	
Market Year Begin		01/2002		01/2003		01/2004	MM/YYYY
Filter Production	132764	132764	129750	107672	0	104750	(MIL PCS)
Non-Filter Production	250	250	250	250	0	250	(MIL PCS)
TOTAL Production	133014	133014	130000	107922	0	105000	(MIL PCS)
Imports	15355	15355	44000	34151	0	32000	(MIL PCS)
TOTAL SUPPLY	148369	148369	174000	142073	0	137000	(MIL PCS)
Exports	72369	72369	100000	68073	0	65000	(MIL PCS)
Domestic Consumption	76000	76000	74000	74000	0	72000	(MIL PCS)
TOTAL DISTRIBUTION	148369	148369	174000	142073	0	137000	(MIL PCS)